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SUBJECT: CZECH REPUBLIC: 2005 INVESTMENT CLIMATE STATEMENT

REF: STATE 250356

11. Post's updated investment climate statement for 2005 follows para 2.

12. THE INVESTMENT CLIMATE

Maintaining an open investment climate has been a key element of the Czech Republic's transition from a Communist, centrally planned economy to a functioning market economy. The Czech Republic's stable political and economic environment, its location on the doorstep of the European Union, its low cost structure and its well-qualified labor force make it an attractive destination for foreign investment. Prior to its accession to the European Union on May 1, 2004, the Czech government harmonized its laws and regulations with those of the European Union. The Czech economy has experienced moderate growth in the past few years. A rising government budget deficit could put continued growth at risk in the medium to long term, particularly if the current strong direct foreign investment flows slow down and European demand remains weak. The Czech government offers attractive incentives for foreign direct investment. Legally, foreign and domestic investors are treated equally. Enforcement of intellectual property rights is improving. According to U.S. Embassy calculations, the U.S. is currently the third largest investor in the Czech Republic, behind Germany and the Netherlands.

Openness to Foreign Investment

For several years, the Czech Republic has received more foreign direct investment (FDI) per capita than any other country of the former Soviet bloc. Gross Domestic Product (GDP) has been growing recently (2.9% in 2003, and an estimated 3-4% in 2004), based largely on significant inflows of foreign investment and growing consumer demand supported in part by rising wages influenced by that investment. Foreign investment is boosting productivity, creating new jobs and raising wages and domestic consumption. It is also contributing to a trend of appreciation in the value of the Czech currency, the crown. This phenomenon is helping to keep inflation low (0.1% in 2003, about 3.5% in 2004), but somewhat reduces the competitiveness of Czech exports. Some unfinished elements in the transition, such as slow and uneven enforcement of contracts by the Czech courts, have adversely affected investment, competitiveness, and company restructuring.

There have been numerous major U.S. investments since 1990, and many American firms are looking closely at investing directly into the Czech Republic. The government has harmonized most relevant laws with EU legislation and the so-called "acquis communautaire". This effort has involved positive reforms of the judicial system, civil administration, financial markets regulation, intellectual property rights protection, and many other areas important to investors. While there have been many success stories, a handful of investors have experienced problems, mainly in heavily regulated sectors of the economy such as the media and in enterprises where the state is a partner. Investors also complain about difficulties in enforcing contractual rights, including security interests. The slow pace of the court system is often compounded by judges' lack of familiarity with commercial cases. Needed reforms of the system for registering companies and the bankruptcy laws have been slow in coming. Concerns about corruption have been voiced by foreign and domestic businesses alike.

Organizational Structure of Investments

Foreign investors can, as individuals or business entities, establish sole proprietorships, joint ventures, and branch offices in the Czech Republic. In addition, the government recognizes joint-stock companies, limited liability companies, general commercial partnerships, limited commercial partnerships, partnerships limited by shares, and associations. The government imposes a Czech language requirement for issuance of the trade licenses needed for most forms of business. The requirement has been waived for citizens of EU countries, and under the terms of the U.S.-

Czech bilateral investment treaty should be waived for U.S. citizens as well.

National Treatment

Legally, foreign and domestic investors are treated identically. Both are subject to the same tax codes and laws. The government does not differentiate between foreign investors from different countries, and does not screen foreign investment projects other than in the banking, insurance and defense sectors. Upon accession to the OECD, the Czech government agreed to meet (with a small number of exceptions) the OECD standards for equal treatment of foreign and domestic investors and limitations on special investment incentives. The U.S.-Czech Bilateral Investment Treaty contains specific guarantees of National Treatment and Most Favored Nation treatment for U.S. investors in all areas of the economy other than insurance and real estate. (See the section on the Bilateral Investment Treaty below)

Exempted Sectors

According to CzechInvest, the Czech agency tasked with attracting and facilitating FDI, all sectors of the Czech economy are open to foreign investment. Investors in banking, financial services, insurance and broadcast media sectors must meet certain licensing requirements. Some professions, such as architects, physicians, lawyers and tax advisors, require memberships in the appropriate professional chamber. These licensing and membership requirements apply equally to foreign and domestic investors.

Privatization

More than eighty percent of the Czech economy is now in private hands after several waves of privatization of formerly state-owned companies since 1989. Privatization programs have been open to foreign investors. In fact, most major state-owned companies have been privatized with foreign participation. The government evaluates all investment offers for state enterprises. Non-transparent and unfair practices have been alleged in connection with some recent privatizations.

Conversion and Transfer Policies

The Czech crown is fully convertible for business purposes, including all trade transactions and investment transactions with one limitation: non-resident foreign individuals and companies without registered offices in the Czech Republic cannot purchase real estate. Imports or exports of more than 350,000 Czech crowns in cash, travelers' checks or money orders must be declared at the border.

The U.S.-Czech Bilateral Investment Treaty guarantees repatriation of earnings from U.S. investments. A 15% withholding tax is charged on repatriation of profits from the Czech Republic. This tax is reduced under the terms of applicable double taxation treaties. For instance, under the U.S. treaty, the rate is 5% if the U.S. qualifying shareholder is a company controlling more than 10% of the Czech entity, and 15% otherwise. There are no administrative obstacles for removing capital. The law permits convertibility into any currency. The average delay for remitting investment returns meets the international standard of three working days.

Expropriation and Compensation

The Embassy is unaware of any expropriation of foreign investment since 1989. Acquisition of property by the government is now only for public purposes (similar to property condemnation in the United States for public works projects) in a non-discriminatory manner, and in full compliance with international law. It is unlikely that any investor losing property due to a governmental taking would not receive full compensation.

Another issue of concern to foreign investors in the Czech Republic is restitution. In 1990 and 1991, the federal government of Czechoslovakia enacted various laws aimed at compensating those people whose property was confiscated by the communist regime during the period of 1948-1989. Under the restitution laws, persons have the right to claim compensation for property taken from them by the communist government. Most claims for restitution of non-agricultural property had to be filed by October 31, 1991, and agricultural property by December 1992. There were additional open seasons for claims in 1994 and 1998 respectively but all deadlines for these claims expired on July 8, 1999. In 2000, however, a new Law to Alleviate Some of the Property Damages Caused by the Holocaust entered into force. It amends the restitution laws allowing the state, subject to certain conditions, to return communal Jewish property, works of art and land illegally seized by the

Nazis to entitled Jewish communities and individuals.

Although deadlines for submitting restitution claims are now past, it is nevertheless important that foreigners seeking to invest in the Czech Republic first ensure that they have clear title to all land and property associated with potential projects. The process of tracing the history of property and land acquisition can be complex and time-consuming, but it is necessary to ensure clear title. Title insurance is not yet offered in the Czech Republic. Investors participating in privatization of state-owned companies are protected from restitution claims through a binding contract signed with the government.

Dispute Settlement

The Czech Republic has a commercial code and a civil code that are largely based on the German legal system. The commercial code details rules pertaining to legal entities and is analogous to corporate law in the United States. The civil code deals primarily with contractual relationships among parties. When the Czech Republic was formed in 1993, the new Czech government maintained the previous commercial and civil codes. The laws have been extensively amended since then, but gray areas still remain. The judiciary is independent, but decisions may vary from court to court. Commercial disputes, particularly those related to bankruptcy proceedings, can drag on for years. Companies registration is in the hands of the courts and is sometimes slow and overly complicated.

The need for an improved bankruptcy law remains an important structural impediment. Most observers believe the slow and uneven performance of the courts and weakness of creditors' legal standing is an impediment to increased lending to small and medium enterprises. The law also lacks provisions for corporate restructuring. The Ministry of Justice has identified bankruptcy reform as a priority and appointed a commission to draft a completely new, effective bankruptcy law. Progress has been slow and competing versions of the law are now under consideration.

The Czech Republic ratified the Convention on the Settlement of Investment Disputes between States and Nationals of Other States in 1993. The U.S.-Czech Bilateral Investment Treaty provides for international arbitration of investment disputes with the state. The Czech Republic has also ratified the New York Convention on the Recognition and Enforcement of Arbitral Awards. As a signatory of the latter convention, it is required to uphold binding arbitration awards in disputes between Czech and foreign parties. However, arbitration of disputes between two Czech corporations outside the Czech Republic is not permitted, even if the owners are foreign. Applications for enforcement of foreign judgments can be made to the Czech courts and will be determined in accordance with a bilateral recognition treaty, if any, or otherwise pursuant to the requirements of Czech law. Judgments rendered in other EU countries are enforceable in accordance with applicable EU regulations.

Investment Incentives

In 1998 the Czech government approved a package of incentives to attract investment. The incentives are offered to foreign and domestic firms that make a \$10 million manufacturing investment through a newly registered company. The package includes relief from corporate taxes for up to ten years, job-creation grants, re-training grants and opportunities to obtain low-cost land. A tax incentive is also available for expansion of an existing manufacturing investment. Subsidies are offered for services centers for software development, customer service and repairs. More recently, subsidies to attract high technology and research and development centers have been added. Tax deductions for new machinery, real estate tax relief, job creation grants, re-training grants, simplified customs procedures and duty-free import of machinery are also available under certain conditions to qualified companies. The incentives were developed with the assistance of the EU in order to ensure their compatibility with EU rules on industrial subsidies. Therefore, there has been no change to the incentive program as a result of the Czech Republic's accession to the European Union.

The Czech Republic is in compliance with WTO TRIMs requirements. There are currently no general performance requirements imposed on foreign firms for establishing, maintaining, or expanding their investments, except in connection with the incentives described above. These performance requirements generally relate to the amount of investment or hiring of employees if special job-creation grants are received with the incentive package. For more information contact CzechInvest, Director Mr. Radomil Novak, phone: 420-296 342 501, fax: 420-296 342 502, address: Stepanska 15, 120 00 Praha 2, Czech Republic,

marketing@czechinvest.org, www.czechinvest.org. Special performance requirements are negotiable.

Foreign workers in the Czech Republic must obtain permits and visas in advance of their taking up employment and residence. The process of obtaining the required permits can be time-consuming.

Right to Private Ownership and Establishment

The right of foreign and domestic private entities to establish and own business enterprises is guaranteed by law in the Czech Republic. Enterprises are permitted to engage in any legal activity with the previously noted limitations in some sensitive sectors. Personal ownership of real estate by non-resident foreign individuals is not permitted, but since January 1, 2002, foreign companies registered to do business in the Czech Republic and Czech branches of foreign entities may own real estate, other than agricultural and forest land. Since May 1, 2004, EU, U.S. and some other nationals can purchase real property if they comply with temporary residence requirements. Czech legal entities, including 100% foreign-owned subsidiaries, may own real estate without any limitations.

Protection of Property Rights

Existing legislation guarantees protection of all forms of property rights, both intellectual and physical. Secured interests in land (mortgages) and in personal property are permitted. Government subsidy programs are making mortgage financing more accessible, and consumers are becoming more used to using both secured and unsecured forms of credit. According to U.S. lawyers in the Czech Republic, enforcing judgments and foreclosing security interests in land and personal property can still be difficult in practice.

Major amendments to the Commercial Code came into force in 2001 that strengthen protection of creditors and minority shareholders. The law includes detailed provisions for mergers and places time limits on decisions by the authorities on registering of companies. New laws on auditing and on accounting were also enacted. These laws include the use of international accounting standards (IAS) for consolidated corporate groups.

The Czech Republic is a signatory to the Bern, Paris, and Universal Copyright Conventions. In 2001, the government ratified the WIPO Copyright Treaty and the WIPO Treaty on Performances and Phonograms. Domestic legislation protects all intellectual property rights, including patents, copyrights, trademarks, and semiconductor chip layout design. Amendments to the trademark law and the copyright law have brought Czech law into compliance with relevant EU directives and WTO TRIPS requirements. Changes to the civil procedure code, effective January 1, 2001, provide for ex parte search and seizure in enforcement actions. The Czech Republic increased copyright protection for literary works from 50 to 70 years, effective December 1, 2000, and boosted the powers of the customs service and the Czech Commercial Inspection to seize counterfeit goods. The Embassy continues to work with U.S. industry and Czech government officials to further improve enforcement of intellectual property rights.

Transparency of the Regulatory System

Tax, labor, environment, health and safety, and other laws generally do not distort or impede investment. Policy frameworks are consistent with a market economy. All laws and regulations are published before they enter into force. Opportunities for prior consultation on pending regulations exist, and all interested parties, including foreign entities, can participate. A biannual governmental plan of legislative and non-legislative work is available on the Internet, along with information on draft laws and regulations (often only in Czech language). Comments can be and are made by business associations, consumer groups and other non-governmental organizations, including the American Chamber of Commerce.

However, bureaucracy and unnecessary red tape remain a source of complaints by both domestic and foreign investors. Delays and allegations of corruption are common, especially in the process of registering companies and changes to corporate structure, and are of particular concern to foreign companies operating in the Czech Republic.

In content and principle, Czech competition policy meets OECD standards. A new Act on the Protection of Economic Competition entered into force in 2001, adopting rules consistent with EU competition policy as regards restrictive agreements, abuse of dominant position and merger control.

Efficient Capital Markets and Portfolio Investments

The government privatized the last state-owned bank in 2001 and foreign-controlled banks now manage 90% of total banking

assets. The banking sector has recovered from the 1998-99 recession, the poor payment discipline of many of the banks' clients, and non-competitive loans offered in the early 1990s. Stricter oversight by the central bank has been imposed. Commercial banks have returned to profitability after posting losses in 1999. As of April 1, 2004, the total assets of commercial banks stood at \$14.1 billion. As of the same date, non-performing loans amounted to 11.2% of total credit volume, compared to 28.8% in 2000. This figure does not include non-performing loans (with a face value of \$5.5 billion as of March 31, 2003) transferred to the Czech Consolidation Agency, which is charged with liquidating them. Foreign investors have access to bank credit on the local market, and credit is generally allocated on market terms. In 2002, the banks for the first time established a mechanism for sharing credit histories of borrowers.

The Czech securities market is still handicapped by a poor reputation generated by several years of lax regulation, fraud and scandals. Market capitalization of equities traded on the Prague Stock Exchange was 27.0% of GDP in 2003. Only a handful of stocks are actively traded. The first successful initial public offering of a company's shares since the stock market opened in 1992 took place in 2004. In 1998 the government created a Securities and Exchange Commission to function as capital market watchdog. The Commission has made important strides in establishing a regulatory framework for Czech capital markets and enforcing new rules. It has employed a large number of new staff. A new securities law was adopted in 2001 to improve regulation of brokers and dealers. Legislation adopted in 2002 gives the SEC more flexibility in issuing guidelines and requiring reporting of information.

Political Violence

The risk of political violence in the Czech Republic is extremely low. The Czech lands have never had a history of political violence or terrorism in modern times. Two recent historic political changes -- the "Velvet Revolution" which ended the Communist era in 1989 and the division of Czechoslovakia into the Czech Republic and Slovakia in 1993 -- occurred without loss of life or significant violence.

Corruption

Current law makes both giving and receiving bribes criminal acts, regardless of the actor's nationality. Jail sentences have been increased to up to eight years for officials, with stiffer penalties for bribery previously enacted by Parliament. Bribes cannot be deducted from taxes. Law enforcement authorities are responsible for combating corruption. These laws are applied equally to Czech and foreign investors. The Czech Republic ratified the OECD anti-bribery convention in January 2000.

While there has been no lack of public accusations and suspicions of bribery, only a few cases have reached the prosecution and conviction stage. Allegations of corruption are most pervasive in connection with the court-controlled system of company registration and the police. Such allegations have also been raised in the course of recent privatizations and government procurements. A new government procurement law, required for EU accession, is intended to curb illegal activities in this sphere. The Transparency International chapter in the Czech Republic actively conducts public information campaigns through distribution of posters and has given numerous broadcast and print media interviews on corruption and bribery cases. In 2004, the government proposed legislative changes and other actions to reduce corruption in public life.

Bilateral Investment Agreements

The former government of Czechoslovakia signed a bilateral investment treaty (BIT) with the United States, which came into effect in 1992. The Czech Republic adopted this treaty after the split with Slovakia. Changes to the treaty were agreed with the Czech Republic after extensive negotiations with the EU Commission and the Czech government during 2003. The amendments were narrowly tailored to meet EU concerns about perceived conflicts with the EU *acquis communautaire*. Subsequently, the Czech government is seeking further changes to the treaty that would affect its coverage and dispute settlement provisions. To date, 70 countries have signed and ratified similar agreements with the Czech Republic. They include: Australia, Austria, Belgium-Luxembourg, Bulgaria, Canada, China, Denmark, Finland, France, Germany, Greece, Hungary, Israel, Indonesia, Italy, Jordan, Kazakhstan, Lebanon, North and South Korea, Mongolia, Norway, Paraguay, Poland, Russia, Slovakia, South Africa, Spain, Sweden, Switzerland, Thailand and the United Kingdom. Agreements with other countries are in the process of ratification. A bilateral U.S.-Czech Convention on Avoidance of Double Taxation has been in force since 1993.

OPIC and Other Investment Insurance Programs

Finance programs of the Overseas Private Investment Corporation (OPIC), including investment insurance, have been available in the Czech Republic since 1991. Investors are urged to contact OPIC's offices in Washington directly for up-to-date information regarding availability of services and eligibility. The OPIC InfoLine (202) 336-8799 offers general information 24 hours a day. Application forms and detailed information may be obtained from OPIC, 1100 New York Avenue, NW, Washington D.C. 20527. The Czech Republic is a member of the Multilateral Investment Guarantee Agency (MIGA).

Labor

The wide availability of educated, low-cost labor on the doorstep of the more expensive Western European labor market is a major attraction for foreign investors, particularly those looking to invest in manufacturing industries. Wages and benefits are on the rise, but the Czech Republic will still have far lower labor costs in the year 2004 than those in Western Europe. There are currently no significant shortages of specialized labor skills, though foreign investors still cite weaknesses in middle-management levels. Various factors, including rigidities in the housing market, reduce the mobility of Czech workers within the country.

By law, all workers have the right to strike once mediation efforts have been exhausted, with the exception of workers in sensitive positions (nuclear power plant operators, military, police, etc.) Significant labor unrest remains rare, particularly in the private sector. Public sector unions, notably the rail workers and health workers, have staged strikes when the government tried to limit public sector wage increases. Increased labor activity has been noted in mining and steel industries due to current economic problems. Workers in the Czech Republic have the legal right to form and join unions of their own choosing without prior authorization. Currently, about one-third of the total labor force is a member of some labor organization. The overall number of union members has fallen sharply since 1991, reflecting the fact that union membership is no longer compulsory.

The Ministry of Labor and Social Affairs sets minimum wage standards. On January 1, 2001, a new labor code entered into force, harmonizing domestic rules with the EU. The standard workweek is 40 hours. Caps exist for overtime. Workers are assured 30 minutes of paid rest per work day and annual leave of at least four weeks per year.

Foreign-Trade Zones and Free Ports

Czech law permits foreign investors involved in joint ventures to take advantage of commercial or industrial customs-free zones into which goods may be imported and later exported without depositing customs duty. Duties need be paid only in the event that the goods brought into the free zone are introduced into the local economy. The investment incentive package also permits duty-free import of high tech goods and creation of additional foreign-trade zones.

Currently authorized foreign trade zones in the Czech Republic are Cheb, Ostrava, Pardubice, Prague (2), Zlin, Trinec, Bor u Tachova, Frantiskov nad Ploucnici and Hradec Kralove. Rules for operations within a commercial or industrial customs-free zone are the same as in the EU.

Foreign Direct Investment Statistics

According to data compiled by the Czech National Bank and the U.S. Embassy, the stock of foreign investment in CR (including reinvestment of profits) totaled \$41.1 billion in 1993-2003 (56.4% of 2002 GDP). Germany and the Netherlands are officially the leading foreign investors. Their investments totaled \$11.3 billion (31%) and \$9.6 billion (26.0%) respectively, followed by the United States and Austria with \$3.6 billion (10.1%) each, France with \$2.2 billion (6%), UK with \$1.9 billion (5.2%). Other major investors include Belgium, Switzerland and Slovakia. In 2002 inward flows of FDI reached \$9.3 billion (13.3% of GDP and the second largest inflow per capita in Central and Eastern Europe, after Slovenia; as for FDI stock per capita, the Czech Republic is number one among these countries). The upswing in investment since 1998 is generally attributed to the introduction of investment incentives, as well as the Czech Republic's natural advantages.

By sector, from 1993-2003 foreign direct investment flowed into manufacturing (\$11.9 billion or 32.6%), financial services (\$5.8 billion or 16%); trade, hotels and restaurants (\$4.8 billion or 13.1%); transportation and telecommunications (\$7.3 billion or 20%); real estate and business activities (\$3.6 billion or 9.8%); and electricity, gas and water supply (\$2.0 billion or 5.4%). Other sectors

attracting foreign investment included mining and construction. Government officials anticipate the steady inflow of investment to continue, augmented among others by the eventual sale of the government shares in companies like the electrical utility CEZ and the telecom company Cesky Telecom.

The stock of Czech direct investment abroad totaled \$1.4 billion as of December 2002. The flow of Czech investment abroad was \$276 million in 2002, with principal destinations of Slovakia (40%), followed by Slovenia (26%), British Virgin Islands (11.0%), and the U.S. (4.6%).

Significant foreign investors include:

U.S.

Conoco/Dupont	\$665 mil
Philip Morris	\$420 mil
Pepsi-Cola	\$291 mil
International	
Coca Cola	\$200 mil
IFC Kaiser	\$176.4 mil
Cable, Design and	\$170 mil
Technology (CDT)	
Ford Motor Company	\$115 mil
E.M. Warburg Pincus	\$110 mil
and Co. LLC	
Proctor and Gamble	\$109 mil

Other Countries

RWE Gas AG	Germany	\$3.6 bil
Toyota/PSA	Japan/France	\$1.3 bil
KBC Bank NV	Belgium	\$1.2 bil
Volkswagen AG	Germany	\$1.2 bil
Societe Generale	France	\$1.0 bil
ING Holdings	Netherlands	\$936 mil
Philips	Netherlands	\$733 mil
South African	South Africa	\$619 mil
Breweries		
Kappa Packaging	Netherlands	\$445 mil
BV		
Siemens	Germany	\$373 mil
Daewoo	Korea	\$357 mil
DHL	Germany	\$230 mil

Sources of data for this report included the Czech Statistical Office, the Czech National Bank, CzechInvest, OECD and Central European Advisory Group.

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